Benefits of mergers and acquisitions to strategic buyers and impact on post-merger integration

Understanding why certain industries need to make acquisitions is important in forecasting M&A activity and the efforts required to integrate combined businesses post-acquisition, writes Danny Po

Merger and acquisition activity is often associated with private equity funds and other financial investors. However, such activity only accounts for a minority of transactions. In particular, larger transactions are very often undertaken by strategic buyers. This is especially true when stock markets trade at historical high valuations and financial buyers looking for an attractive return on investment can be outbid by a corporate buyer with deep pockets looking to make strategic acquisitions.

In the current environment, it is interesting to explore some of the reasons for large corporates to allocate capital to M&A activity in order to detect some underlying themes.

Securing resources, brands and technologies
Completing an acquisition can sometimes be critical to preserving an existing business model. Guaranteeing a continued supply of raw materials has been a critical objective in China over the last few years in commodity rich countries.

Gaining access to intellectual property may also provide significant benefits. High profile investments in the information technology and technology sectors by large Chinese groups, such as Lenovo, have focused in this area, especially with China’s stated objective of developing its home market.

Other industries such as cosmetics and pharmaceuticals have long been attractive to strategic buyers, in order to gain access to patents and other intangibles.

Brand names can also be an area of focus for strategic buyers. The fashion industry has seen a lot of M&A activity, for example in order to secure the right to use popular brand names.

This has been the case in the fashion industry, such as for example Gieves and Hawkes, which was founded in the 18th century to provide tailoring for the British Navy, and has since been acquired by a Hong Kong conglomerate to be distributed across Asia and especially in China.

The requirements to promptly integrate buyer and target are not always critical in this case and can be a progressive effort to rationalize costs and assets of the combined business.

Accessing new markets
Further down the supply chain, the acquisition of distributors can sometimes provide an opening to sell existing products into new markets. Although occasionally significant in size, the benefits derived from such investments are typically not "transformational" and are largely aimed at preserving existing capabilities, and/or enabling continued organic growth through new or existing distribution channels.

This type of strategy can also assist in vertically integrating a business. For example, a manufacturing group can achieve vertical integration by acquiring its own distributor, thereby locking in higher margins and controlling its entire supply chain.

Bargainers need to execute their strategic objectives while remaining mindful of any regulatory requirements (or any other local sensitivities). Such “tuck-in” investments require skilled management to prepare and execute the acquisition plan to derive maximum value. For a listed group, an investment in a small distributor may be based on a relatively lower multiple of earnings than its own valuation by the stock market, providing immediate value.

A “light touch” post-merger integration may be more successful for such acquisitions. Ensuring management of target has the right incentives may be equally important.

Industry consolidation
Acquiring a competitor can be a good way to remove excess supply from a market, especially in “older” industries with little or no growth, or niche players with few rivals. The pricing power gained as a result may justify these transactions and may be a good way to allocate surplus capital.

Such transactions can be seen in an unfavourable light by customers, if they lead to higher prices. Managers need to weigh the benefits of undertaking such acquisitions. Although such acquisitions may be comparatively simpler to execute by management, the roadblocks (regulatory and other) may be more complex to overcome.

The efforts in rationalizing the combined businesses are likely to be very significant, and a time consuming post-merger integration exercise is critical to a successful outcome.

Investing in the future
Certain groups, for example Google in the United States with YouTube, may have a strategy that involves investing early in companies with potential in order to unearth successful businesses at relatively cheaper prices and integrating them into their business.

Management will require a high level of skill in order to develop the new business into a successful venture. Ideally, the acquirer will be able to rely on prior experience of similar ventures, backed by strong internal resources (e.g. infrastruc-
ture, knowledge of market, and capital). This type of approach may certainly yield some great successes but will almost certainly result in some failures along the way. The structure of the acquisition and the experience of the management are hugely important in making such investments a success.

Large corporate groups are increasingly building their internal M&A functions to undertake such transactions and “buy growth.” GE Capital in the U.S., and large Chinese corporate groups such as Fosun, Alibaba, or Dalian Wanda are good examples in this area.

Part of the benefits of such M&A activity is the in-house ability to combine, nurture and grow business, meaning that post-merger integration is likely to be the most important factor in determining the viability of the target business and its ultimate success.

Diversification
Dominant groups, for example conglomerates which dominate small markets or geographies may decide to reinvest profits in other markets or jurisdictions in order to make their profits less volatile. This is often the case for groups with a significant controlling shareholder, for example a family-controlled group.

This may not benefit the individual investor, who may be able to hedge his portfolio more efficiently himself by acquiring investments which are more focused on an industry or a geography. Diversified conglomerates may struggle to develop and grow all their different business segments in parallel, and often end up focusing on a few growth areas only. In this case diversification may instead lead to “diworsification,” as capital is misallocated to acquiring other businesses whose potential is not maximized.

Post-merger integration can achieve some very good results, albeit the combined businesses will continue to typically remain independent, even though they may share resources and assets to a certain extent.

Improving performance
A common link to the themes listed above is to improve performance either by way of revenue growth, or through efficiencies achieved by reducing costs, or even with a better control over working capital requirements.

Larger acquisitions are often justified on the basis of improving performance, either because they are a combination of some (or all) of the above reasons, or because they cannot be justified by specific strategic objectives. Such transactions can be described as “transformational” aiming to completely change a business model.

It seems preferable to be prudent in valuing the benefits of such mergers or acquisitions. The premium paid in order to acquire a desirable business partner may require very significant synergies in order for the investment to be a successful one. Forecasting the benefit of this transformation may often be hard, if possible, with the various parties involved often being incentivized to be optimistic about the benefits.

The integration of the businesses in order to transform the combined businesses is a complex and fraught exercise. If the forecasted synergies cannot be achieved then the transformation that was hoped for may not take place.

Post-merger integration – a key theme
We have listed above some common reasons for corporates to undertake M&A. In most cases, the success or failure can be linked to successful post-merger integration of combined businesses, as a way of squeezing every drop of growth from an acquisition.

As Asian strategic investors increasingly look to undertake complex, cross-jurisdiction M&A, dedicating resources to planning post-merger integration should be higher on their agenda when considering transactions. In many cases, it is no longer good enough to manage an acquisition as a completely separate business. Fully integrating and combining acquired businesses will likely be a key differentiator in the success of M&A in coming years.

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